7 Inflation

Inflation is regarded as regressive taxation against the poor. The most visible impact of inflation in recent times is its effect on real output, relative prices, taxes and interest rates. It also discourages saving and promotes consumption. The effect of inflation severity is more social than economic due to the erosion of the real value of money the real value of money. The recent inflationary environment in the country may be blamed to some extent for lower deposit growth and lower savings.

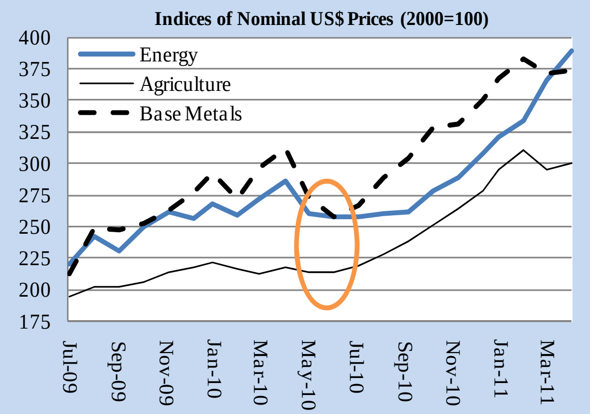
Historically, Pakistan is accustomed to lower inflation and thus has less tolerance towards higher double digit inflation. In this backdrop persistence of high double digit inflation for third year in a row has become intolerable and the government is pursuing combination of several policy measures such as the control of the budget deficit through appropriate fiscal and monetary policies, the improvement of agricultural productivity, the fostering of investment to stimulate output and the constant vigilance on the market situation to ensure the adequate availability of consumer goods to the common man at a reasonable price to bring inflation down to a tolerable and sustainable level.

The year 2010-11 is the most eventful year for the world inflation. The inflation poses serious threat to macroeconomic stability around the world. More worrying thing is that the recent spike in inflation is coming more from food inflation which is detrimental for poverty situation, According to ADB study, a 10 percent rise in food inflation is likely to deteriorate poverty situation by 2.7 percentage points. Therefore, the recent strategy of containing inflation aims at alleviating poverty on the one hand and safeguard the average consumer against the hardships of rising prices on the other.

The beginning of the current year 2010-11 in Pakistan saw number of unfavourable factors impacting the supply and demand situation which created imbalances in the economy. Massive floods swept through one-fifth of the country and caused massive damages to crops, livestock and infrastructure which resulted in sharp acceleration in the commodity price and spike in inflation. The acute shortage of items of mass consumption necessitated substantial imports at rising landed cost. While on the production front, the imported inflation via pass through effect of escalating oil prices consequently raised transport freights, production cost of materials and a substantial hike in all the consumable items or services. Some Structural problems of power outages and weaknesses in the supply chains impacted the real sectors production performance added yet another push factor to the general price hike trend.

The global prices are also adding fuel to the fire as commodity and crude oil prices surged at unprecedented pace since July 2010. Pakistan's problem compounded as all price indices of global prices surged at a massive rate [See Fig-7.1]. The pass through of international prices impacted prospects for domestic inflation. Inflationary forces in many countries tended to become assertive and caused concern to the government and the people alike. Inflation around the world tracked movement in world oil prices through impacts on energy prices and then lagged impacts on other commodity prices.. The continued improvement in global economic growth is driving demand for oil and grains in emerging market economies. Generally immune countries from global commodity price movement like India and China had reported higher inflation, recently. On the positive note, major price indices have started decelerating in March 2011 after eight consecutive months of brisk increases in all price indices.

Fig-7.1: Major Global Price Indices



Source: World Bank

Pakistan's domestic structural problems and global commodity price movement collectively provided momentum to inflation in recent months. The cumulative inflation rose to 14.1 percent in July-April 2010-11. During most of the period, food remained the major driver of inflation on the back of major supply disruption owing to flood. The government's reform program is critically important as it is trying to restore macroeconomic stability in the country which ultimately led to price stability.

The inflationary pressure necessitated a tight monetary policy to suppress the aggregate demand. SBP has kept its discount rate at 14 percent unchanged for last three policy announcements after raising the policy rate by 150 basis points in three instalments. On the fiscal side, the government is applying strict adjustment to bring down fiscal deficit in line with the availability of adequate financing. The government has formed a high powered Committee chaired by the Finance Secretary and all provincial Chief Secretaries are members to look into identifying interventions within the framework of market mechanism to smoothen supplies of consumer items and allowing markets to function well. Administrative steps have been taken by the government to enhance supply of essential commodities like sugar, edible oil and pulses etc through imports

Price Trends

During the current fiscal year 2010-11 an upward trend persisted in all indices used to measure various kind of inflation. CPI inflation averaged at 14.1 percent, WPI 23.3 percent and SPI inflation increased at 18.2 percent for July-Apr 2010-11 which is higher than the corresponding period of last year. The underlying factors for this spike are; rising international oil prices, spike in textile products prices and shortages of key consumer items in the market. Table-7.1 and Fig 7.2 depict the average rates of inflation for three price indices.

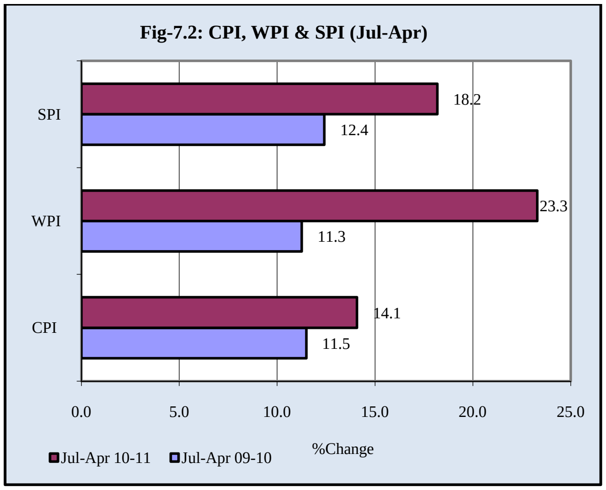
Table-7.1: Trend in Inflation (Various Price indices)
(% Change)

Items		July-April	
		2009-10	**2010-11**
A	**Consumer Price Index (CPI)** (374 Items & 35 Cities)	11.5	14.1
B	**Wholesale Price Index (WPI)** (425 Items & 18 Cities)	11.3	23.3
C	**Sensitive Price Indicator (SPI)** (53 Items & 17 Cities)	12.4	18.2

Source: FBS

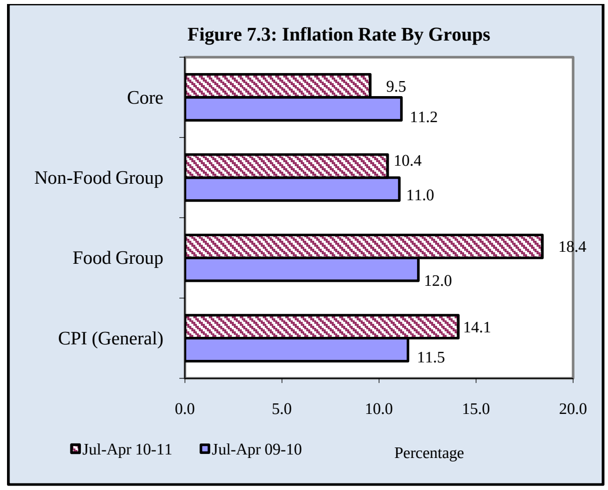
Inflation in 2010-11

Inflation as measured by the changes in Consumer Price Index (CPI) has escalated by 14.1 percent in July-April 2010-11 as against 11.5 percent in the comparative period of last year. During this period food has remained the major driver of the inflation on the back of major supply disruptions owing to devastating floods as well as spike in imported fuel and food stuff prices. Food inflation is persistently rising and recorded at 18.4 percent as against 12.0 percent in the comparable period of last year. Non-food component witnessed an increase of 10.4 percent in this period which shows some adjustment against 11 percent in the comparable period of last year. Non-food inflation either stagnated in this period or registered modest decline but its contribution to rise in overall inflation is 52.6 percent while food inflation accounted for 47.4 percent increase in CPI inflation. The contribution is mainly because of higher weight of non-food (59.7 percent) as food accounts for 40.3 percent stake in the index. The non-food non-energy measure or core inflation estimated at 9.5 percent during the course of year remained subdued over corresponding increase of 11.2 percent on the back of tight monetary policy, weaker economic activity and base impact.



The category-wise analysis of the CPI basket shows that food inflation has worked as stimulant in the index with its 18.4 percent increase. The non-food category is categorized in further sub-groups. The highest increase among these sub-groups at 16.5 percent has been observed in transport group followed by energy group 14.9 percent, medicine group 14.5 percent and textile group 11.7 percent. These three groups have an impact of pass through of higher global fuel and commodity prices.

Another important contributing factor has been the higher prices in the crop sector of agriculture, which injected additional cash of Rs.444 billion in the rural areas in a single year 2010-11 as against increment of just Rs.415 billion in eight years (2000-08) and during last three years cumulative injection of Rs.906 billion. This is translating into creation of additional demand for goods and services in the rural areas. This factor combined with excellent growth in the remittances of 22 percent has caused real growth of 7 percent in private consumption and huge growth in import and production of durables. These factors are responsible for providing support to inflation momentum in the economy. Monetary policy became ineffective in curtailing this outburst of private consumption. The fiscal policy remained profligate inspite of concerted efforts for fiscal adjustment.



There are many other supply side factors as well that has contributed to the food and non-food inflation in Pakistan. The unstable food supply/demand fundamentals are driving up prices. On the demand side, the sharp increase in world oil prices with a consequential impact of translating into domestic prices, shortfall in production of some essential items and a significant increase in world food stuff prices like palm oil and rice during 2010-11 were the major contributors to domestic inflation. Crude oil is up by around 61 percent in the global market and partial pass through has resulted in higher domestic market prices. This is followed by 40 percent rise in sugar prices and 42 percent increase in the palm oil prices during July-April 2010-11. This inordinate spike is being translated into domestic prices. The surge in global food and fuel prices is not the Pakistan specific problem as it is confronting many developing countries including regional players.

Pakistan is regarded as one of the agrarian economies with high dependency on agriculture. However, food imports comprises sizeable portion of imports as it account for 13.5 percent of imports in July-March 2010-11 and contributed 38 percent increase in imports. Pakistan has imported 1.02 million tons of sugar, 1.4 million tons of edible oil (palm oil), 0.5 million tons of pulses and 94.3 thousand tons of tea. This shows sensitivity of domestic food prices to global price movement and domestic food security upon global food supplies. To minimize the impact of imported inflation, efforts have been made to substitute imported food items with local production. Half hearted and reluctant efforts failed because of not properly sequencing incentives to increase production of major food and cash crops. The country has adequate scope of expanding and diversifying import basket as well as concentrate to improve the supply position through better management of stocks in the short-run and increase production in the medium and long term periods.

Table: 7.2 Annual CPI Inflation by Major Groups

Commodity Group	Weight	(July-Apr)		Point Contribution (July-Apr)	
		2009-10	2010-11	2009-10	2010-11
		Percent		Percent	
CPI	100	11.5	14.1	11.5	14.1
Food	40.3	12.0	18.4	4.9	7.4
i) Perishable	5.14	14.5	35.1	0.7	1.8
ii) Non perishable	35.2	11.7	16.0	4.1	5.6
Non-Food	59.7	11.0	10.4	6.6	6.2
Core*	52.4	11.2	9.5	5.7	4.9
Apparel, Textile	6.1	5.8	11.7	0.4	0.7
House Rent	23.4	14.6	7.2	3.4	1.7
Energy	8.7	10.5	14.9	0.9	1.3
Transport	7.3	4.7	16.5	0.2	0.9
Household	3.3	6.4	9.9	0.2	0.3
Recreation	0.8	4.2	11.9	0.0	0.1
Education	3.5	13.3	6.0	0.5	0.2
Cleaning	5.9	10.9	11.5	0.6	0.7
Medicare	2.1	6.0	14.5	0.1	0.3

*Core Inflation (I) is defined as overall inflation adjusted for food and energy

Source: Federal Bureau of Statistics

The surge in non-food inflation is mainly because of surge in global fuel prices as well as second round impact of food and fuel inflation. POL prices as a key input in various economic activities and its impact on domestic prices was inevitable through pass adjustment in retail oil prices, electricity tariff and gas charges, which affected the domestic cost of transportation, production and distribution of goods and services and ultimately acceleration in inflation. The imported inflation through escalation of oil prices has been a major source of cost push inflation.

Table-7.3: Change in price Indices in energy related items

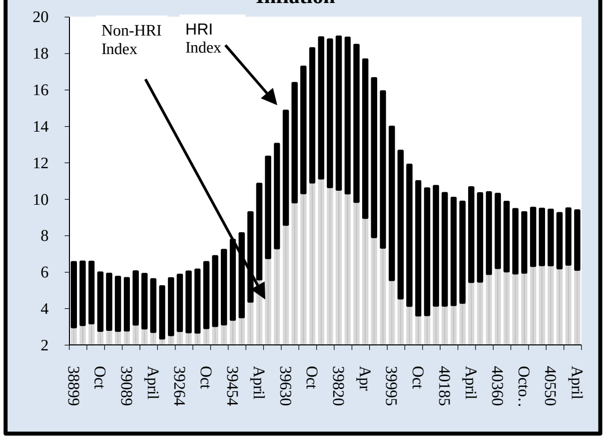
Non-food Items	Weight	%Change	(% Point Contribution
Kerosene	0.14	13.2	0.0
Electricity	4.37	20.9	0.9
Natural gas	2.05	8.5	0.2
Petrol	1.73	8.5	0.1
Diesel	0.21	14.6	0.0
Cng. Filling charges	0.16	9.8	0.0
Total	8.66		1.3

Components of Core Inflation

The core inflation excludes the impact of food and energy and truly reflects the component of inflation that is more sensitive to policy measures. Alarming thing is Y-o-Y increase in ***core inflation*** which started building up after three months consecutive decline. House Rent component (Accounting for 45.9 percent of Core inflation) of core inflation was persistently decelerating for last 23 months since April 2009 but reversed in March 2011 as it witnessed first upward movement. It decelerated from as high as 18.9 percent in April 2009 to 6.5 percent in February 2011. However, it inched up to 6.6

percent in March and 7 percent in April 2011. On the other hand non-HRI component of Core inflation (accounting for 54.1 percent weight in Core index) started inching up from its lowest level of 6.4 percent in October 2009 and entered into double digit in April 2010. It remained in the double digit for the last 12 months and accelerated to 11.7 percent in April 2011. Second round impact of food inflation is visible on this component when it has gone up by 2.6 percent on M-o-M basis in April 2011. This is the highest ever M-o-M build-up in the index since April 2010.

Fig-7.4: HRI & Non-HRI Components of Core Inflation



Main culprits for this escalation were inordinate rise in prices of cleaning, laundry and personal appearances, and prices of apparel and textiles. As one can see from Fig-7.4, the non-HRI component of the core inflation is playing an even more important role in build-up of core inflation. Non-HRI component increased by 11.9 percent in July-April 2010-11 as compared to 7.2 percent increase in HRI component of the core inflation. The situation was altogether different in 2009-10 when HRI component increased by 13.8 percent and non-HRI component increased by8.3 percent. The main contribution in 2009-10 was coming from HRI component while in the current fiscal year the contribution is coming primarily from non-HRI component.

Inflation By Income Groups

Inflation measures for different groups finds that Inflation hurts the poor more as their 50 percent expenditure goes to food. A review of disaggregated inflation with respect to different income groups reveals that variability is higher for vulnerable lower income groups than upper income groups. This is the result of higher expenditure incurred among the lower income groups on necessities with more variable prices i.e food. Cumulative inflation incidence for lowest income groups is 15.3 percent which is highest incidence among all income groups. On the other hand, the incidence of inflation is lowest for highest income group and it is far lower than lowest group inflation at 13.6 percent.

Fig-7.5: Inflation by Income Groups

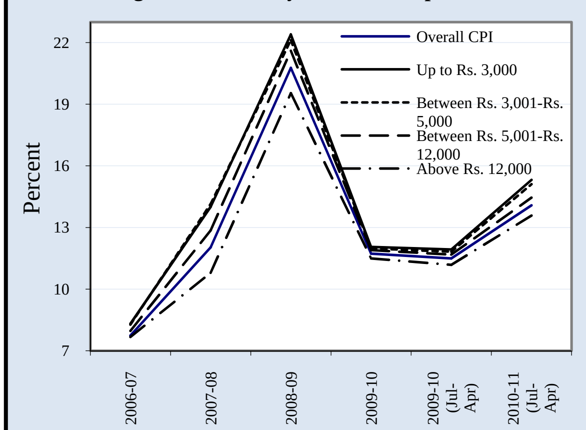


Table –7.4: Inflation Rate by Income Groups

Period	Overall CPI	Up to Rs. 3,000	Between Rs. 3,001-Rs. 5,000	Between Rs. 5,001-Rs. 12,000	Above Rs. 12,000
	(Y-o-Y percentage change, period average)				
2006-07	7.7	8.3	8.3	8.0	7.7
2007-08	12.0	14.0	14.1	12.9	10.8
2008-09	20.8	22.4	22.1	21.6	19.5
2009-10	11.7	12.1	12.0	11.9	11.5
2009-10 (Jul-Apr)	11.5	11.9	11.8	11.7	11.2
2010-11 (Jul-Apr)	14.1	15.3	15.1	14.5	13.6

Source: FBS

Wholesale Price Index

The Wholesale Price Index (WPI) during July-April 2010-11 has increased by 23.3 percent, as against 11.3 percent in the comparable period of last year. The recent spike is mainly driven by upsurge in textile and energy prices. WPI has moved up from 17.6 percent in June 2010 to 25.9 percent in April 2011.

Table 7.5: Components of WPI (% change)

Commodity Groups	Weight	July-April		%age Point contribution July-April	
		2009-10	2010-11	2009-10	2010-11
WPI	100.0	11.3	23.3	11.3	23.3
Food	42.1	11.4	19.7	4.8	8.3
Non-Food	57.9	11.1	26.2	6.4	15.1
Raw Material	8.0	24.6	64.5	2.0	5.2
Fuel & Lubricants	19.3	13.5	15.0	2.6	2.9
Manufacturers	25.9	8.2	27.7	2.1	7.2
Building Materials	4.7	-9.2	13.0	-0.4	0.6

Source: Federal Bureau of Statistics

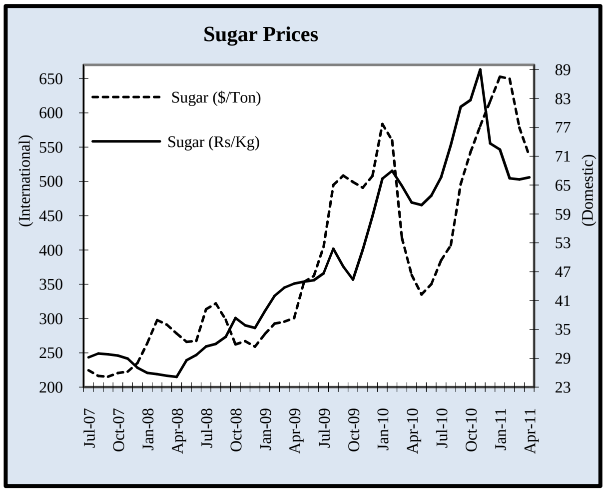
The category-wise inflation shows that the raw material group registered the highest increase of 64.5 percent mainly stemming from the massive rise in cotton and cotton related prices. The damage to cotton crops by floods and rise in external demand for cotton related exports and massive surge in international prices were factors behind higher cotton prices. The impact is also visible in manufactures sub-groups. Among other groups of WPI suggests that in the food category, the supply shocks have adverse impact on food inflation and was more visible in prices of heavy weights like pulses, rice meat, milk, sugar and vegetables, clearly associated with flood related disruptions [See Table-7.6]. Some commodities influenced price situation in the manufacturing category of WPI include fertilizers and soap where rise in cost of its imported inputs and power tariff hike contributed to general price rise. Rise in fuel group is the combined impact of relatively higher energy and fuel prices in relation to rising international prices which is outside the control of policy purview.

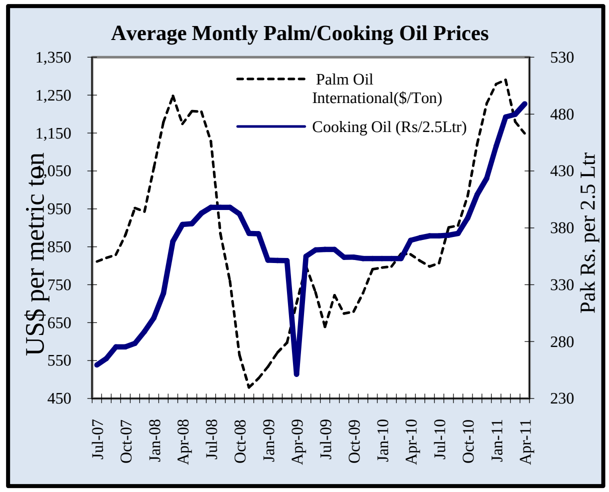
Table –7.6: Individual Items of WPI (% change)

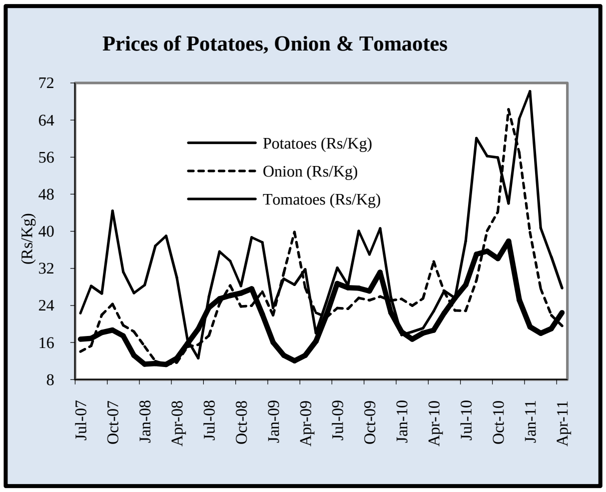
Items	Weight	%Change Jul-Apr 2010-11/ Jul-Apr 200-10	*%Point Contribution*
Rice	0.71	12.82	0.09
Gram	0.21	10.33	0.02
Sugar	3.12	32.36	1.01
Vegetable Ghee	2.50	33.29	0.83
Tea	0.22	11.29	0.03
Meat	3.99	27.90	1.11
Vegetables	0.77	47.41	0.36
Milk	4.05	16.62	0.67
Cotton	1.48	106.36	1.58
Cotton Yarn	1.81	68.75	1.25
Motor Fuel	1.53	8.46	0.13
Other Oils	0.23	13.86	0.03

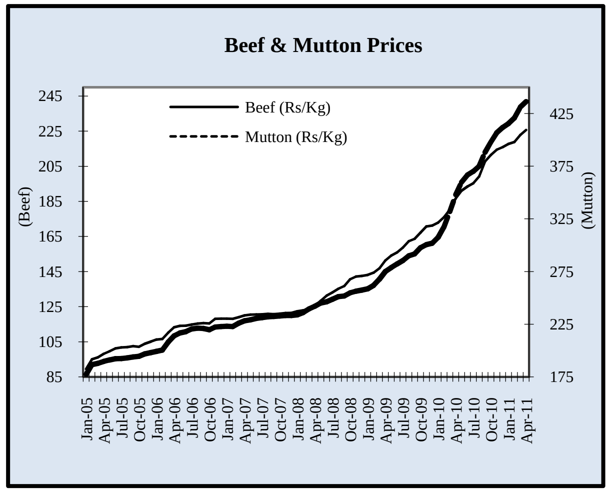
Source: Federal Bureau of Statistics

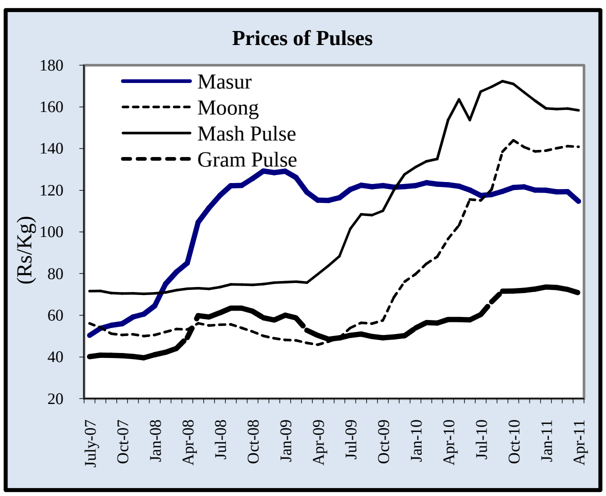
Fig-7.6: Price Movement in Essential Items

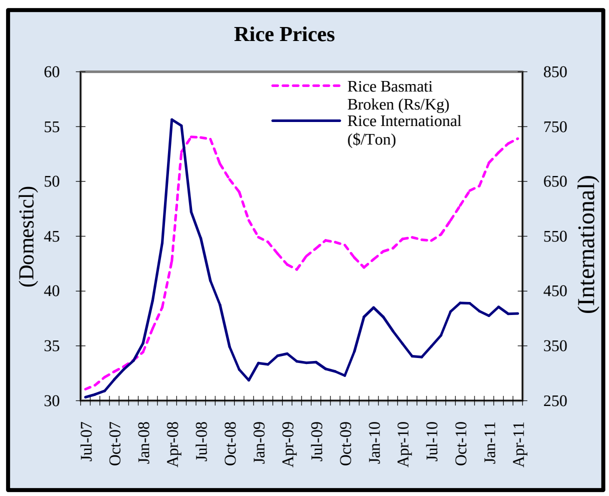












SPI Inflation

Rising food prices contributed to acceleration of inflation across the country. CPI food inflation increased sharply this year and the same impact was witnessed in SPI with period average inflation of 18.2 percent during July-April 2010-11. Following the general rise in prices, all type of inflation covered under different groups of

SPI are on the rise with pronounced hike in food group inflation 13.2 percent. The impact was more visible in prices of pulses, rice, meat, sugar, edible oil and vegetables. A variety of factors can be taken into account to explain rise in food prices component of SPI including shortfall in production of some essential items and a significant increase in world food stuff prices like palm oil and rice during 2010-11. The spike in the SPI index persists on the back of persistence of supply disruptions, utility price adjustments and still high crude oil price. The weighted contribution of non-food prices to the overall SPI is 1.5 percent. Inflation of utility items group is estimated at 3.6 percent and that of transport related items group at 0.62 percent. Inflation in the non-food category of SPI appears to be driven by increase in prices of diesel, petrol, gas, CNG and power tariff rates which translated into higher freight and production costs and thereby acceleration of inflation.

Table-7.7: Contribution of Price-Hike of Utilities and Transport related items in SPI

Non-food Items	Weight In SPI	%change Jul-Apr 2010-11/ Jul-Apr 2009-10	% point contribution
Kerosene	0.22	14.94	0.03
Electricity	10.94	19.77	2.16
Gas	2.12	9,8	0.21
Petrol	5.16	10	0.52
Diesel	0.31	16.14	0.1
LPG.	0.16	29.18	0.09
Total	**18.91**		**3.11**

Source: FBS

Pakistan Vs World Inflation

Commodity prices in 2010-11 have increased more than expected mainly because of combination of strong demand growth and supply disruptions of essential items. Many analysts are drawing parallels with the specter of 1970s-style stagflation. However, they are not hurting the economic recovery as combination of the decreasing share of oil, the disappearance of wage indexation, and the anchoring of inflation expectations diluted major impact on growth and core inflation. The challenge is even stronger in developing economies where the share of food and fuel in consumption basket is larger and the credibility of monetary policy is often weaker.

In developing countries like Pakistan fluctuations in international prices translate rather quickly into domestic prices as their ability to intervene through fiscal means is limited. The inflationary pressures this year emanates from spike in the cost of grain and pickup in oil prices. The oil prices are rising largely as a result of demand rebound in global industrial activities while surge in food prices is largely a consequence of supply shocks caused by bad weather and competing food grain.

The FAO food price index (FFPI) averaged 232 point in April 2011, 36 percent above April 2010 while ADB study finds a rise of 10% in domestic prices of regional countries in early of 2011. The surge in global food prices prevailed across most Asian countries including Pakistan with food price inflation (18.4 prices) doubling in 2011.

South Asia posted the highest median inflation rate among developing regions in the second half of 2010. Inflationary pressures were up across most economies in the region in 2010-11. Partly rising inflationary pressures stem from recent firming in international fuel and food prices. However, domestic drivers contributed with much vigor to higher prices, including;

- elevated capacity utilization rates,
- accommodative macro policy stances
- increased inflationary expectations following several years of rising inflation.
- Temporary price shocks, such as the disruption of flooding in Pakistan and;

- some liberalization of fuel-price subsidies in India.

The significant inflation differential between many South Asian countries and their trade partners has contributed to a real appreciation of their currencies in 2010. Notably, much of the appreciation during the year represents a reversal of depreciation in the aftermath of the global financial crisis. And, since January 2007 regional currencies have remained broadly stable, trading within a plus/minus 10 percent band —with the exceptions of Pakistan where currency real effective exchange rate depreciated by 34 percent since January 2007, partly tied to large and persistent structural macroeconomic imbalances. Pakistan's inflation is slightly different from other regional partners as extra market forces played much important role here along with market.

Outlook for Inflationary Environment

Based on the current trend of inflation reported for the first ten months of this year (July-April) 2010-11 at 14.1 percent, the overall inflation rate implying that inflationary trends persists in the economy. Next fiscal year will see stabilization of supplies of major commodities on the domestic front and commodity prices have already started losing momentum in March 2011. The persistence of prevailing uncertainty in the Middle East is likely to determine oil prices movement in oil importing countries. Pakistan is likely to undergo some tariff adjustment in the utilities in the year to come to release pressure on the budget. However, prices of food items are likely to be stabilized and any downward revision of petroleum prices is contingent upon stability in the Middle East. The government is also working on policy interventions to lower inflation in a meaningful way. These interventions include; pursuing tight monetary policy, augmenting stock through timely imports, and strengthening the network of USC to do away the shortage of key consumable items. Additionally, price monitoring mechanism is being strengthened at grassroots levels. Commodity supplies are expected to respond to higher prices in 2011. This enhanced the prospects of lower inflation in the next fiscal year.